IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR PETITIONER

MARK H. BERENS,
LEE N. ABRAMS,
JOHN E. ALLEN,
DOUGLAS A. POE,
231 South LaSalle Street,
Chicago, Illinois 60604,
312-782-0600,
*Attorneys for Petitioner,
Thor Power Tool Co.*

Of Counsel:
MAYER, BROWN & PLATT.

Gunthorp-Warren Printing Company, Chicago • Financial 6-6565

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I.

INVENTORY ISSUE*

Reduced to its elements, Respondent's argument is a syllogism that misconceives both the facts and law. As Respondent sees it, in 1964 Thor took a current writedown for a future inventory loss; it was a future loss because it was unrealized; therefore, Thor's 1964 income was not clearly reflected.

1. Respondent fundamentally misunderstands the nature of Thor's excess inventory writedown, which it describes repeatedly as an anticipation of, or a reserve for, a future loss

* Thor is aware that this Court views extended reply briefs with disfavor. Unfortunately Respondent's brief, which introduces a major new argument, and urges affirmance on the basis of issues not reached by the lower courts, requires a comprehensive reply (pp. 16-24 and 32-48) so as to fully advise this Court of the relevant facts and law.

(Resp.Br. 22-23, 26 (heading), 32, 41-42, 58 (heading), 61-62, 64 n.29). This characterization flies in the face of the Tax Court's finding that Thor's 1964 writedowns ". . . resulted in petitioner's stating the inventory in issue at its estimate of *current* net realizable value" (emphasis added) (Pet. A-15)—a finding based on the unanimous and uncontradicted testimony of the expert accounting witnesses.

2. Respondent does not attempt to evaluate either Thor's writedown, or the Commissioner's contention that excess inventory cannot be written down until it is scrapped or its selling price reduced ("scrapping rule"),[1] in terms of the plain requirements of §§ 446 and 471.

Section 446(a) requires taxable income to be ". . . computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Can this straightforward requirement be nullified simply by asserting that the Commissioner has the authority under § 446(b) to determine, without explanation, that Thor's inventory procedures do not clearly reflect its income? Respondent identifies no standards by which the Commissioner is to make this determination (see Resp.Br. 36-37).

Apart from contending that inventory losses cannot be taken until they are "realized", nowhere does Respondent offer any explanation how Thor's writedown of excess inventory to net realizable value did not clearly reflect its 1964 income within the meaning of either § 446 or § 471. Nor does Respondent offer any illumination as to how income could be clearly reflected, as mandated by those sections, by carrying unsalable inventory year after year at cost instead of at its much lower estimated current realizable value. As the Fifth Circuit stated in *Space*

1. It is wholly unrealistic to require a taxpayer to try to sell the estimated excess portion of an item at scrap value while he simultaneously attempts to merchandise salable quantities at normal prices (see Pet.Br. 68 and A61-A62, A128-A130). Inasmuch as such dual pricing is an impossibility, to require it is tantamount to saying that no taxpayer can write down excess inventory until it is scrapped—wherefore the "scrapping rule".

Controls, Inc. v. *Commissioner,* 322 F.2d 144, 154 (5th Cir. 1963):

> ". . . it would hardly be a true reflection of the financial condition of that concern were its inventory of dedicated goods valued at an amount which it could never get."

Respondent likewise bypasses the key question of how the scrapping rule can fulfill the conjunctive requirement of § 471, binding on the Commissioner and taxpayer alike, that the taxpayer's inventory must conform to the best accounting practice in its trade or business. The scrapping rule *cannot constitute a best accounting practice* because it contravenes generally accepted accounting principles (see Pet.Br. 13, 55, 59-61, and testimony of the experts at A114, A130-A131, A133, A156, A158, A176, A192-A193, A195).

3. Instead of examining the language of the statute and the legislative intention, Respondent relies on the Treasury Regulations, which can do no more than implement the statutory intention.

Respondent's appeal to the Regulations is selective. Although the Regulations under § 446 and § 471 both embody the principle that a taxpayer's income "ordinarily" and "as a general rule" will be regarded as clearly reflected if its inventory procedure is consistent with generally accepted accounting principles and constitutes the best accounting practice, these presumptions are dismissed as inapplicable because they admit of exceptions (Resp.Br. 36, 40). We are not told what these exceptions are or how they apply to this case. Instead, Respondent turns to the ". . . detailed provisions of the Regulations upon which this case must ultimately turn" (Resp.Br. 38).

Respondent's construction of the detailed provisions of the inventory Regulations also is highly selective. Broad language of the Regulations that can be construed in conformity with the statutory intention is subordinated to mechanical provisions which Respondent reads literally and narrowly even though they are not directed to the problem of valuing excess inventory (Resp. Br. 45-53).

4. This uneven reading of the Regulations is reinforced by radically distilling from them, and by engrafting from non-inventory cases, the proposition that inventory losses cannot be deducted before they are realized (Resp.Br. 31-32, 48, 56, 57-58). This concept, which never before has been applied to the valuation of inventories by a taxpayer using the lower-of-cost-or-market inventory valuation basis, provides the theoretical foundation of Respondent's contention that excess inventory cannot be written down to net realizable value until it is scrapped, or at least until it is offered for sale at a price below its cost. The introduction of the concept of realization ignores the entire administrative and judicial history of inventory accounting for tax purposes and embodies a fundamental confusion between the concept of "income and loss" and that of "realization".

5. Overshadowing the misunderstanding of the nature of Thor's writedown, the subordination of the statutory intention to the skewed interpretation of the Regulations, and the interjection of the realization criterion, is a remarkable reliance by the Respondent on the discretion of the Commissioner. See *amicus* brief of the National Association of Manufacturers, pp. 4-5. Respondent asserts that to the extent Congress created any presumption whether income is clearly reflected,

> ". . . it is in favor of the Commissioner's judgment that a method of accounting does not clearly reflect income. That judgment can only be set aside if the taxpayer meets the 'heavy burden of proving that the Commisioner's action was plainly arbitrary.' " (Resp.Br. 36-37.)

In like manner, whether an inventory procedure conforms to the "best accounting practice in the trade or business" is not to be determined by the accounting profession, but is to be decided by the Commissioner (Resp.Br. 33). There is no mention in Respondent's brief of the standards by which the Commissioner is to make these difficult determinations other than by reference to the language of the Regulations—which Respondent treats as controlling even though their provisions were drafted without the problem of valuing excess inventory in mind.

6. In addition to its principal argument, Respondent asserts, for affirmance on alternative grounds, that at the end of 1964 Thor changed its "method of accounting" without the prior permission of the Commissioner as required by § 446(e) (Resp. Br. 65-71). The Tax Court rendered no decision on this complex issue (see Pet. A-41, n.12), after correctly ruling that the Commissioner had the burden of proof on it (A14, A19, A30-A32). Accordingly, if this Court determines that this issue is relevant and that further proceedings are necessary, at most remand rather than affirmance would be appropriate.

The record does not support Respondent's factual allegations, but even if they are treated as fully proven, such a change by Thor would not constitute a change in its "method of accounting" within the meaning of § 446(e). Thor's inventory *method* remained FIFO and standard cost, and its *basis of valuation* remained the lower-of-cost-or-market. Moreover, any such change did not, and could not, cause the omission of income or a double deduction (*e.g.*, a double increase in Thor's cost-of-goods-sold), which is the *sine qua non* of a change to be within the scope of § 446(e). Thus, remand is not appropriate either.

7. Respondent further argues that the excess inventory valuation procedures employed by Thor at the end of 1964 resulted in opening and closing inventory for that year being calculated on an inconsistent basis, so that a portion of the $927,000 writedown properly belonged in such prior years (Resp.Br. 19, 39 n.19).[2] By pretrial order, the Tax Court excluded evidence on this point from the initial trial (A14, A19), reserved it for future hearing if it became relevant (A207-A208), and

2. Respondent's brief, p. 19 and especially p. 39 n.19, contains serious factual errors. Contrary to what is stated, the Commissioner did not disallow Thor's 1964 excess inventory writedown because its opening and closing inventories were not valued on the same basis; that theory originated shortly before trial three years after the statutory notice of deficiency was issued (see A16, A20). The Tax Court did not find that Thor's opening and closing inventories were valued on a different basis; see the Seventh Circuit's opinion (Pet. A-41 n.12).

therefore made no finding on this issue (see Pet. A-41 n.12).[3] Accordingly, while this issue may be grounds for remand, it is not an alternative basis for affirmance.[4]

A. Respondent's Arguments are Based on Major Misconceptions of the Record

Again and again, Respondent asserts, without citation to the record, that Thor's writedown of excess inventory at the end of 1964 constituted an anticipation of a future loss (Resp.Br. 22-23, 26 (heading), 32, 41-42, 58 (heading), 61-62, 64 n.29). This is contrary to the Tax Court's finding that Thor's 1964 inventory procedures ". . . resulted in petitioner's stating the inventory in issue at its estimate of *current* net realizable value" (emphasis added) (Pet. A-15). The Tax Court's finding is supported by the unanimous and uncontradicted testimony of the accounting witnesses that Thor's writedown represented a loss existing at the end of 1964 (see A98-A99, A114-A115, A128-A130, A140-A141, A155-A156, A162-A163, A173-A174, A176, A181-A182, A192-A194, especially the testimony of Mr. Weston quoted at Pet.Br. 55n**).

3. As pointed out in Thor's initial brief (Pet.Br. 70-71), Thor's writedown of excess inventory in 1964 was based on management's discretionary judgment, so that according to both case law and the Commissioner's usual practice, it properly belongs in that taxable year.

4. Respondent raises the question whether the writ of certiorari in this case may have been improvidently granted because of representations in the *amicus* brief of the National Association of Manufacturers (reiterated in Thor's reply to the Government's brief in opposition to the Petition) as to the number of cases involving this inventory issue pending in the Tax Court and the Appellate Division of the Internal Revenue Service (Resp.Br. 26 n.13). Thor is informed by counsel for the NAM that the data on pending cases was obtained from a letter, dated January 18, 1978, to counsel from the Freedom of Information Branch of the Internal Revenue Service. The Service did not reveal the extraordinary circumstances that 374 docket numbers represented a single case.

It is unfortunate that Respondent did not obtain any data from the Internal Revenue Service as to the number of cases pending in the Audit Division, which Thor believes to be unusually numerous.

Regardless of the number of comparable cases now pending, thousands of incorporated and unincorporated manufacturers, wholesalers and retailers of service parts, who use the commonplace lower-of-cost-or-market basis of valuation, are faced with the problem of how to value excess inventory for Federal income tax purposes. According to data published in American Institute of Certified Public Accountants, Accounting Trends and Techniques 111 (1977), at least 40% of all businesses use this basis of valuation.

It is true that the loss in value of the excess inventory was both unrealized and estimated at the end of 1964. But neither of these factors transforms that existing loss into a future loss. A direct analogy is the ordinary situation where goods in an inventory are written down to "market" because their reproduction cost on the inventory date is less than their original cost. The inventory can be written down even though the loss is unrealized, and current reproduction cost usually must in part be estimated. This, as the expert testimony demonstrates, is quite different from a reserve for anticipated future price declines, prohibited by both financial and tax accounting (*e.g.*, A114-A115). No matter how accurate the estimate or how probable or impending the anticipated future price decline, no loss exists on the inventory date so it cannot be the basis of a writedown.

Thor's 1964 writedown of excess inventory was based on the then existing fact that a portion of its inventory exceeded foreseeable demand and therefore was unsalable except as scrap. Thor estimated the extent of this unsalability by comparing the quantities on hand of each of some 44,000 different items to the actual sales or production usage of that item during 1964. By this method, supplemented by certain percentage writedowns for nine categories of goods at two plants where usage data was inadequate, Thor objectively determined the extent of an existing but unrealized loss on the unsalable portion of each item of its inventory.[5]

5. Respondent's brief mistakenly states that Thor's primary writedown procedure for excess inventory was applied to inventory at

(Footnote continued on next page)

Respondent attempts to give substance to the scrapping rule by repeatedly stating that Thor had taken a writedown of $2,750,000 for obsolete inventory at the end of 1964,[6] which the Commissioner allowed because these goods were scrapped "soon after they were removed from its [Thor's] 1964 closing inventory" (Resp.Br. 6, 17, 30-31). This reflects a misunderstanding of the record, which seemingly originated with the opening statement by the Commissioner's trial counsel (Tr. 69-70), for which no supporting evidence was introduced. Unfortunately this unproven statement found its way into the Seventh Circuit's opinion (Pet. A-36). Thor's obsolete goods were gradually scrapped over a five- or six-year period: cumulatively 43% in 1965; 55% in 1966; 60% in 1967; 86% in 1968; and 98% in 1969.[7] The 1964 *excess* inventory was scrapped somewhat more slowly: cumulatively 12% in 1965; 28% in 1966; 28% in 1967; 51% in 1968; 65% in 1969; and 77% in 1970.[8] The record thus refutes Respondent's theory that the Commissioner allowed the writedown of *obsolete* inventory because those items were scrapped shortly after the close of the taxable year, but disallowed the writedown of *excess* inventory because such items were not promptly scrapped.

There is another common denominator between Thor's 1964 writeoffs of obsolete and excess inventory that undermines

(Footnote continued from preceding page.)
only two of its four plants, and that the supplementary percentage writedowns were applied at its other two plants (Resp.Br. 7). The primary formula was applied to the inventory at *all* of Thor's plants and branches. The supplementary percentage writedowns were used in addition to the primary writedowns for limited categories of inventory at two of Thor's four plants (Stip. A25-A26, A60-A61).

6. The correct amount of the obsolete inventory writedown was $1,603,000 (A53).

7. These percentages are derived by subtracting the scrappings of excess inventory (recorded in Ex. 17, A38, A218) from the gross scrappings of obsolete *and* excess inventory (recorded in Ex. 22, Tr. 166, A221). They are overstated because they assume that the only scrapping of obsolete inventory during these years was of stock that was obsolete at the end of 1964.

8. These percentages are understated for the reasons set forth in Pet.Br. 10n.

other arguments of Respondent. The writeoff of obsolete goods, like that of excess goods, was based on Thor's actual sales for 1964: if there was no demand that year for a particular item, it was treated as obsolete and written off (A53). Thus, except for differences of nomenclature, the writeoff of obsolete stock was based on the same procedure as the writeoff of excess goods. If, for example, at the end of 1964 Thor held 500 units each of Items A and B, and sold none of A and 8 units of B during that year, it would have written off all 500 of A as obsolete and 489 of B as excess (see Pet.Br. 8). The Commissioner would allow the entire 500 unit writeoff, but none of the 489 unit writeoff. Is this difference in terminology so decisive under the subnormal goods Regulations (§ 1.471-2(c)) as to permit the writeoff of obsolete but not of the excess inventory? (Compare Pet.Br. 66-68 with Resp.Br. 45-47.) And can it be fairly said that in 1964 Thor changed its method of accounting for excess but not for obsolete inventory? See discussion *infra* at 37-41.

B. Thor's Writedown of Excess Inventory, Unlike the Commissoner's Scrapping Rule, Conforms to Both Requirements of § 471

Respondent's brief treats § 471 as if the clear reflection of income was the only—or the dominant—requirement imposed by that section (*e.g.*, Resp.Br. 35). But the statutory language plainly establishes conformity to the "best accounting practice" as a separate and equal requirement. It was added as a separate requirement by a Senate amendment to the House version of the Revenue Bill of 1918 (see Pet.Br. 33). Floor debate on the Revenue Bill of 1921 reaffirmed it as a distinct test (Pet.Br. 33n***). Continuously since 1922,[9] the Regulations have ex-

9. See Pet.Br. 34.

plicitly recognized that the statute imposes two tests. Article 1582 of Regulations 45 provided in part:

> "The Act provides two tests to which each inventory must conform—(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) It must clearly reflect the income. It follows, therefore, that inventory rules can not be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. . . ."

Section 1.471-2(a) reads identically.

By deemphasizing the "best accounting practice" requirement, Respondent bypasses the troublesome fact that, according to the uncontradicted testimony of the accounting experts, the scrapping rule does not meet this requirement (*e.g.*, A130-A131, A156, A192-A193), whereas Thor's writedown procedures do, as the Tax Court found (Pet. A-15). Thus, in choosing between the Commissioner's scrapping rule and Thor's writedown procedures, only the latter can meet both explicit statutory requirements.

The question becomes whether Thor's writedown for excess inventory clearly reflected its income under § 471 (and under § 446). Thor showed in its initial brief that the case law, generally accepted accounting principles, and the public financial disclosure rules of the S.E.C. all lead to the conclusion that Thor's inventory writedown resulted in its income being clearly reflected for tax purposes (Pet.Br. 54-59). Respondent disputes this by arguing that generally accepted accounting principles "do not govern the computation of federal income tax liability" and that the "accounting methods prescribed by other federal regulatory agencies . . . are not determinative of tax liability" (Resp.Br. 60). But Respondent does not address the question of how generally accepted accounting principles or S.E.C. standards would distort Thor's income for tax purposes.

For over 50 years, from 1922 until after the trial of this case, the Regulations explicitly made the best accounting practice presumptively determinative of the clear reflection of income. Until 1973, Regulation § 1.471-2(b) provided:

> "An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income."[10]

This presumption under § 471 echoes the presumption under the general tax accounting rules of § 446 (which remain in the Regulations, and which appeared virtually *in haec verba* in the explanation of § 446 in both the House and Senate Reports accompanying the 1954 Code) that if a taxpayer's accounting method conforms to generally accepted accounting principles, it ordinarily will clearly reflect income. See Pet.Br. 28-31.

Respondent argues that because these presumptions contain the phrases "ordinarily" and "as a general rule," they are subject to exceptions (Resp.Br. 36, 40). But Respondent offers no guidance as to what these "exceptions" are, under what circumstances they should override the presumptions, or how they are applicable to this case. Thor submits that these presumptions of the Regulations should apply unless the Commissioner can advance some reasonable explanation why in this case they should not.

In rejoinder, Respondent relies exclusively on the supremacy of the Commissioner's discretion to the point of reversing the presumption:

> ". . . to the extent that Congress created a presumption, it is in favor of the Commissioner's judgment that a method of accounting does not clearly reflect income. That judgment can only be set aside if the taxpayer meets the 'heavy burden of proving that the Commissioner's action was plainly arbitrary'." (Resp.Br. 36-37.)

This proposition is justified by citing *Lucas* v. *Kansas City Structural Steel Co.*, 281 U.S. 264, 271 (1930), involving the base stock inventory method which did not conform to generally accepted accounting principles and had been explicitly

10. This sentence was deleted without explanation from the Regulations in 1973 after trial of this case and long after the tax year here involved. See Pet.Br. 34-35 and 32n.

condemned by rulings and Regulations since 1919 (see Pet.Br. 45n). As Thor pointed out in its initial brief, no case has applied the "plainly arbitrary" standard in favor of the Commissioner where the taxpayer's accounting method and procedures conformed to generally accepted accounting principles (see Pet.Br. 51).

Respondent overlooks the fact that the courts, consistent with the presumption of § 1.471-2(b), quoted *supra* at 11, uniformly have held that inventory procedures that constituted the best accounting practice and conformed to generally accepted accounting principles do clearly reflect income. See Thor's initial brief (Pet.Br. 38-43), citing especially *E. W. Bliss Co.* v. *United States*, 351 F.2d 449 (6th Cir. 1965), *adopting the District Court's opinion*, 224 F.Supp. 374, 385 (N.D. Ohio 1963); *Space Controls, Inc.* v. *Commissioner*, 322 F.2d 144, 149 (5th Cir. 1963); and *Van Pickerill & Sons, Inc.* v. *United States*, 445 F.2d 918, 920-21 (7th Cir. 1971).[11] It is noteworthy that both *Space Controls*, 322 F.2d at 147, and *Bliss*, 224 F.Supp. at 379, involved *estimates of future costs* to determine an existing but unrealized loss (which Respondent concedes at least as to *Bliss*, Resp.Br. 54).

Respondent further argues that the presumptions of the Regulations cannot be read "so as to override other specific provisions of the Regulations" because that would "virtually render meaningless the detailed provisions of Sections 1.471-1 through 1.471-9 of the Regulations" (Resp.Br. 40).[12] This

11. Respondent seemingly misunderstands (Resp.Br. 53-55) the import of Thor's citation to those cases (Pet.Br. 38-43). Thor's point is that until the decisions below the Courts of Appeals for three Circuits and the Tax Court uniformly have held that income is clearly reflected if the taxpayer's inventory procedures conform to generally accepted accounting principles, regardless whether these procedures were explicitly authorized by the Regulations. Respondent attempts to distinguish those cases on their facts, but such factual differences are not relevant to Thor's thesis.

12. The specific provisions of the inventory Regulations can, by their very detail, create a conflict with the statutory requirement of best accounting practice. In commenting, at the request of the Com-

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argument ignores that § 1.471-2(b), which articulates the presumption, requires only that a taxpayer's "method of inventorying or basis of valuation" be "substantially in accord" with the detailed provisions of the Regulations. But unless the detailed provisions of the Regulations are construed (see Pet. Br. 64-68) to permit Thor's writedown which constitutes the best accounting practice (and to prohibit the Commissioner's scrapping rule which does not), the Regulations in effect will nullify the plain statutory requirement that inventory procedures must constitute the best accounting practice. Regulations can only implement and interpret the statute, not render part of it meaningless. In explaining the relative roles of the statute and the Treasury Regulations, this Court stated in *Manhattan General Equip. Co.* v. *Commissioner*, 297 U.S. 129, 134-35 (1936):

> ". . . A regulation which . . . operates to create a rule out of harmony with the statute, is a mere nullity. . . . And not only must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable. . . .
>
> ". . . The statute defines the rights of the taxpayer and fixes a standard by which such rights are to be measured. The regulation constitutes only a step in the administrative process. It does not, and could not, alter the statute."

See also *Helvering* v. *Credit Alliance Corp.*, 316 U.S. 107, 113 (1942); and *Koshland* v. *Helvering*, 298 U.S. 441, 447 (1936).

Independent of the supremacy of the statute, it is appropriate to accord less than usual significance to the detailed provisions of the Regulations where, as here, they were drafted without adequately covering the problem of valuing excess inventory.

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missioner, on the proposed (1973) amendments to the inventory Regulations under § 471, the Division of Federal Taxation of the A.I.C.P.A. observed (Ex. 29, A151, A223-A224):

> "It should also be noted that in attempting to achieve the objective of conforming tax and financial accounting, it is inconsistent for tax accounting rules to be spelled out in such great detail as is the case in these proposed regulations. This detail, in effect, promulgates new accounting principles rather than adopts generally accepted accounting principles, where applicable, for federal income tax purposes."

Respondent correctly asserts that the detailed provisions of the Regulations can be deemed to have legislative assent because of multiple reenactments of the Revenue Acts and subsequent codifications (Resp.Br. 37-38).[13] But it is a very large step to conclude that this legislative assent includes a prohibition of excess inventory writedowns because they were not explicitly covered by the Regulations. All the cases cited by Respondent in support of legislative assent construed regulations which resolved matters not fully covered by the statute.[14] None involved the situation where, as here, the Regulations failed to provide relevant guidance; where the Commissioner was aware for many years that the Regulations were inadequate but did nothing to resolve the problem (see Pet.Br. 63-64); and where for a number of years the Commissioner interpreted the Regulations to permit the writedown of excess inventory, and then, without any amendment of them (and in the absence of any judicial decision) commenced to disallow such writedowns. See Patton, *Inventory Procedures: Recent Developments in Internal Revenue Service's Attitude*, 23 N.Y.U. Institute on Federal Taxation 839, 850 (1965).

* * *

Thor submits that there can be no stronger case for giving effect to the statement long contained in the Regulations that generally accepted accounting principles will normally clearly reflect income than the present case, in which the evidence is undisputed that Thor's excess inventory writedown conformed to generally accepted accounting principles and no explanation has been given by the Commissioner as to why that writedown did not clearly reflect income. Respondent's argument that

13. Thor relies on the same rule to show legislative assent to the general provisions of the Regulations (Pet.Br. 35-37).

14. *Bingler* v. *Johnson*, 394 U.S. 741, 749-750 (1969); *Commissoner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); *Fulman* v. *United States*, 434 U.S. 528 (1978); *United States* v. *Correll*, 389 U.S. 299 (1967); *Helvering* v. *Winmill*, 305 U.S. 79 (1938); *Lykes* v. *United States*, 343 U.S. 118 (1952); *United States* v. *Catto*, 384 U.S. 102 (1966).

he has discretion to ignore the presumptions under both § 446 and § 471, and that their application conflicts with the detailed provisions of the inventory Regulations (which no one contends are specifically directed to the problem of valuing excess inventory), should be insufficient to nullify them. If the presumptions in favor of generally accepted accounting principles are not given effect here, and the Commissioner's scrapping rule is upheld, the best accounting practice requirement will in substance have been written out of the statute.

C. The Regulations Do Not Prohibit Thor's Writedown of Excess Inventory

Respondent's reliance on the supremacy of the Regulations is stated unequivocally (Resp.Br. 38): "We therefore turn to the detailed provisions of the Regulations upon which this case must ultimately turn." From this premise, Respondent argues that Thor's valuation procedures:

(i) are specifically prohibited by § 1.471-2(f);

(ii) are prohibited because they do not conform to the detailed rules of § 1.471-2(c) authorizing the writedown of subnormal goods or of § 1.471-4 governing the valuation of goods at the lower-of-cost-or-market; and

(iii) are inconsistent with the rationale of §§ 1.471-2(c) and 1.471-4, which can be interpreted to require that any writedown of goods be realized by scrapping, or at least confirmed by reducing the price at which the goods are offered for sale.

Respondent vacillates between insisting on a strict scrapping rule, or allowing price decreases as sufficient "objective" evidence. Compare Resp.Br. 57-58 with 48. The latter alternative is wholly unrealistic because it would require Thor to try to sell the estimated excess quantities of repair parts at scrap value while simultaneously attempting to merchandise salable

quantities at normal prices (see Pet.Br. 68 and A61-A62, A128-A130). To require dual pricing is tantamount to saying that no taxpayer can ever write down excess inventory until it is scrapped. The cases have not required such impracticality. See discussion *supra* at 25-26 and 28.

Despite its extended analysis of these regulatory provisions, Respondent's brief ignores the Commissioner's acknowledgment in Announcement 76-115, I.R.B. 1976-36, p. 16, and in Revenue Procedure 76-28, 1976-2 C.B. 645, 646, that *excess* inventory writedowns are possible under both the subnormal goods and market value Regulations (see Pet.Br. 69). This acknowledgment intimates that the Commissioner recognizes that inventory writedowns not specifically authorized by the Regulations may nonetheless be proper.

1. *Section 1.471-2(f) Is Not Intended to Prohibit Thor's Excess Inventory Writedown.* Respondent introduces an entirely new argument in this case by contending that any of three provisions of § 1.471-2(f) preclude Thor's writedown of excess inventory (Resp.Br. 40-45). Section 1.471-2(f) prohibits:

> "(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.
>
> "(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.
>
> "(3) Omitting portions of the stock on hand."

Not only is this argument novel to this case, but Thor cannot find any decision citing these prohibitions to invalidate an inventory method or procedure that conformed to generally accepted accounting principles or constituted a best accounting practice[15]. This novelty casts upon this argument the cloud

15. The narrow scope accorded these prohibitions may be gleaned from the fact that Thor can find only five cases in some 56 years that have cited § 1.471-2(f)(1) through (3) and its lineal predecessors: *Burton Coal & Lumber Co.*, 22 B.T.A. 133, 135 (1931) (taxpayer attempted to claim a deduction for estimated depreciation of merchandise); *S & R Chevrolet Co.* v. *Birmingham*, 93 F.Supp. 950, 962-63 (N.D. Iowa 1950) (summarized *infra* at 20 n.21); *Ralph Ellstrom*, 14 T.C.M.(CCH) 312, 317, P-H

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that it is a "*post hoc* rationalization" of appellate counsel which this Court has rejected under the *Chenery* rule as an inadequate substitute for a sound reason for an administrative agency's actions. See *FPC* v. *Texaco Inc.*, 417 U.S. 380, 397 (1974), *citing SEC* v. *Chenery Corp.*, 332 U.S. 194, 196 (1947); *NLRB* v. *Pipefitters Local No. 638*, 429 U.S. 507, 522n. (1977). As such it should be given little or no weight.[16]

The prohibitions of § 1.471-2(f) first appeared in Article 1582 of the 1920 edition of Regulations 45, as amended by T.D. 3296 (approved March 3, 1922), I-1 C.B. 40 (1922), and can be traced in part to two major rulings of the Treasury Advisory Tax Board, T.B.R. 48, 1 C.B. 47 (1919) (prohibiting "average value" method in costing inventories), and T.B.R. 65, 1 C.B. 51 (1919) (prohibiting both the base stock method and reserves for inventory price fluctuations). These prohibitions were developed at a time when tax accounting was in its infancy, and the Treasury was confronted with the problem of identifying and prohibiting unsound inventory practices. They were immediately commended as consistent with accepted

(Footnote continued from preceding page.)

TC Mem.Dec. 55-260, 55-264 (1955), *aff'd per curiam*, 235 F.2d 181 (6th Cir. 1956) (summarized *infra* at 19 n.17); *Kenneth B. Kaar*, 16 T.C.M.(CCH) 355, 357, P-H TC Mem.Dec. 57-301, 57-303 (1957) (summarized *infra* at 19 n.18); *Ernest, Holdeman & Collet, Inc.*, 19 T.C.M.(CCH) 42, 50-51, P-H TC Mem. Dec. 60-43, 60-54 (1960), *aff'd on other grounds*, 290 F.2d 3 (7th Cir. 1961) (writedown of used machines sustained even though many were later sold at prices substantially in excess of taxpayer's valuation).

16. As the following discussion in the text demonstrates, Respondent attempts to apply § 1.471-2(f)(1)-(3) by analogy. Thor submits that it is not appropriate for this Court to decide in the first instance whether these provisions should be extended to cover inventory procedures that conform to generally accepted accounting principles. Taxpayers are entitled to rely with reasonable certitude on an established interpretation of the Regulations. A determination, in effect retroactive, that this Regulation has a scope much broader than its plainly intended purpose and prior application would violate that principle, particularly as there may be many accounting procedures now considered proper that may be somewhat analogous to those forbidden by § 1.471-2(f).

financial accounting principles by Robert H. Montgomery, then the leading commentator on tax accounting: "The five methods which are specifically disapproved [in Article 1582] are in themselves technical departures from good accounting practice." Montgomery, Income Tax Procedure 459 (1922 edition). This background supports the conclusion that none of these prohibitions were intended to apply to Thor's writedown of excess inventory, because it conformed to generally accepted accounting principles. The three prohibitions will be analyzed individually under (i), (ii) and (iii) below.

(i) Thor's excess inventory writedown at the end of 1964 was not equivalent to a "reserve for price changes, or an estimated depreciation in the value" of the inventory within the meaning of § 1.471-2(f)(1). As was shown earlier, *supra* at 6-7, Thor's writedown was for an existing loss, not an anticipated future loss. Expected price changes or other anticipated future depreciation simply were not involved at all.

Respondent's brief reflects its misunderstanding of the facts when it states that:

> "Given this explicit prohibition in the Regulations, it is hardly surprising that the courts have rejected such percentage write-downs of inventory, whether *the anticipation of diminished realization* arose from changes in styles or general price levels, excess supplies, supervening technology, disadvantageous changes in the geographic or business environment, or otherwise. [Footnote omitted.] In seeking write-downs based upon estimates of diminished demand, petitioner would require the Court not only to invalidate Section 1.471-2(f)(1) of the Regulations but also to disapprove a body of case law that extends back even prior to the promulgation of T.D. 3296 in 1922." (Emphasis added.) Resp.Br. 42-43.

Footnoting this passage, Respondent cites some 22 cases, none of which are factually similar to this case. All are distinguishable in one and sometimes several of the following major respects:

(a) accounting procedures explicitly prohibited by the Regulations;[17]

(b) hybrid methods of accounting prohibited prior to the 1954 Code;[18]

(c) percentage writedowns [of] an *entire* inventory because a *portion* of the inventory had declined in value;[19]

(d) valuation procedures that the court found did not conform to generally accepted accounting principles;[20]

(e) estimated percentage writedowns of an entire inventory or broad categories of it, which the trial court

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17. *Western Dry Goods Co.* v. *United States,* 34 F.2d 976 (W.D. Wash. 1929) (valuation of inventory at "normal" cost, a variant of the prohibited base stock method); *Ralph Ellstrom,* 14 T.C.M.(CCH) 312, P-H TC Mem.Dec. 55-260 (1955), *aff'd per curiam,* 235 F.2d 181 (6th Cir. 1956) (valuation of inventory at flat rate to anticipate price changes).

18. *Boston Oldsmobile Co.,* 16 B.T.A. 114, 117-18 (1929), *acq.* IX-1 C.B. 6 (1930) (combination of cost and lower-of-cost-or-market methods); *Kenneth B. Kaar,* 16 T.C.M.(CCH) 355, 357, P-H TC Mem.Dec. 57-301, 57-303 (1957) (arbitrary formula which assumed that a majority of the inventory items were purchased for less than "present cost price"); *O. A. Steiner Tire Co.,* 9 B.T.A. 1289, 1291 (1928) (combination of cost and lower-of-cost-or-market methods).

19. *Adams Motor Co.,* 4 B.T.A. 589 (1926), *acq.* IV-1 C.B. 1 (1927) (deduction from total inventory based on estimate of decrease in value due to inclusion of obsolete items); *Gem Jewelry Co.,* 6 T.C.M.(CCH) 11, P-H TC Mem.Dec. 47-7 (1947), *aff'd on other issues,* 165 F.2d 991 (5th Cir. 1948), *cert. denied,* 334 U.S. 846 (1948) (blanket mark-down of 10% to cover shelf wear, outmoded fashions, market fluctuations and damage).

20. *Brooks-Massey Dodge, Inc.,* 60 T.C. 884, 894 (1973) (20% writedown of used cars below published wholesale prices was not a best accounting method); *Estate of Jones,* 20 T.C.M. (CCH) 26, 30, P-H TC Mem.Dec. 61-30, 61-34 (1961) (48% writedown of house trailers, including new models, was not in accordance with good accounting principles); *Wesley J. Rogers,* 20 T.C.M.(CCH) 1515, 1517, P-H TC Mem.Dec. 61-1657, 60-1659 (1961) (20% annual writedown of defunct variety store merchandise in storage improper because use of annual inventories is inappropriate where stock was not part of an ongoing business); *Leo J. Omelian,* 12 T.C.M.(CCH) 306, 309-10 P-H TC Mem.Dec. 53-296, 53-299 (1953) (novel formula for determining "cost").

expressly determined were unsupported either by current facts or later events.[21]

In sharp contrast to these decisions are a number of cases in which percentage formula writedowns were upheld because the trial court was convinced that the taxpayer had used *its best efforts to value the inventory with a reasonable degree of accuracy.* In *S. G. Sample Co.* v. *Commissioner,* 23 F.2d 671, 672 (5th Cir. 1928), *rev'g* 5 B.T.A. 1034 (1926), the Fifth Circuit held that the Board of Tax Appeals erred in not permitting a clothing retailer an opportunity to prove that a 25% average writedown of its inventory reflected market value. The Fifth Circuit concluded that there was no legal requirement that the taxpayer identify separately the amount of estimated market decline for each item in the inventory.[22]

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21. *John E. Ashe, Inc.* v. *Commissioner,* 214 F.2d 13, 15 (5th Cir. 1954) (percentage writedowns of retail clothing store by items classified as good, fair or poor was "arbitrary"); *R. J. Darnell, Inc.,* 18 B.T.A. 125, 129 (1929), *aff'd,* 60 F.2d 82 (6th Cir. 1932) (evidence of market value found to be merely "conjectures or estimates"); *Sells Lumber & Mfg. Co.,* 14 B.T.A. 96, 103 (1928), *aff'd,* 41 F.2d 363 (6th Cir. 1930) (taxpayer did not establish amount of consigned merchandise still unsold and could not deduct from income unrealized profits thereon); *Ideal Reversible Hinge Co.,* 7 B.T.A. 1066 (1929) (replacement cost was more representative of market value than arbitrary "fair value" determined by taxpayer); *Harry P. True,* 6 B.T.A. 1042 (1927) (judgment of taxpayer not sufficient proof of market value); *Louis Allen,* 2 B.T.A. 1313 (1925), *acq.* V-1 C.B. 1 (1926) (taxpayer discounted all inventory by 2% of purchases for the purpose of reducing it from cost to actual market value); *Alexander Reid & Co.,* 2 B.T.A. 425 (1925) (taxpayer admitted reduction in inventory was an approximation); *Orkin Brothers,* 2 B.T.A. 65 (1925) (evidence "vague and indefinite"); *Saul S. Pearl,* 36 T.C.M.(CCH) 1059, 1065-66, P-H TC Mem.Dec. 77-1060, 77-1066-67 (1977) (items written down to scrap value later sold for prices up to 40 times that value); *Estate of Ginsberg,* 17 T.C.M.(CCH) 472, 481, P-H TC Mem.Dec. 58-406, 58-414 (1958), *aff'd on other issues,* 271 F.2d 511 (5th Cir. 1959) (evidence not sufficient to show writedown justified); *S & R Chevrolet Co.* v. *Birmingham,* 93 F.Supp. 950 (N.D. Iowa 1950) (many used cars against which a reserve was set up were later sold at substantial profits).

22. See also *May Lumber Co.,* 13 B.T.A. 62, 69 (1928) (writedowns, varying from year-to-year, of lumber for estimated deteriora-

(Footnote continued on next page)

Not one of the cases cited by Respondent or by Thor, including those which upheld the taxpayer's inventory procedure, involved a writedown procedure that was as objective and immune from manipulation as Thor's primary formula for writing down excess inventory.[23] Management, in fact, intended it to be such (A65). That formula was based on current sales and production usage, which Thor could not minimize to reduce inventory values without suffering greater and unacceptable economic detriment by lost sales. It was calculated on an item-by-item basis, as § 1.471-4 prefers. It was self-correcting from year-to-year (see Pet.Br. 9). It was subject to annual review by Thor's independent public accountants with a far greater thoroughness than auditors of the Internal Revenue Service can practicably exercise in determining *whether inventory already off the books for financial purposes has in fact been scrapped.*

(Footnote continued from preceding page.)

tion due to handling and exposure to the weather allowed because they were based on a careful evaluation by management); *Justus & Parker Co.,* 13 B.T.A. 127, 130 (1928), *acq.* VII-2 C.B. 21 (1928) (20%, 50% and 100% writedowns by wholesaler of automobile equipment and supplies ". . . by officers . . . familiar with the business and having knowledge of the market value of the material dealt in, is sufficient evidence of the actual market value"); *Lord Motor Car Co.,* 5 B.T.A. 818, 820 (1926), *acq.* VI-2 C.B. 4 (1927) (25% writedown from cost of used car inventory was supported by evidence of actual sales during succeeding year, conformed to statute and Regulations, and clearly reflected income); *The Wickens Co.,* 16 B.T.A. 968, 972 (1929) (10% reduction from cost by furniture retailer approved as "an honest effort to bring the inventory to the basis of cost or market"); *Fred S. Stewart Co.,* 5 B.T.A. 436 (1926), *acq.* VI-2 C.B. 7 (1927) (percentage reductions, applied to several departments of shoe retailer, allowed to establish market value); *Wood & Ewer Co.* v. *Ham,* 14 F.2d 995, 997 (D. Maine 1926) (taxpayer who took percentage reduction of inventory value in several departments of clothing store "made a substantial compliance with the law" in determining fair market value of the inventory).

23. The cases cited by Thor in the preceding footnote upheld percentage writedowns much broader in scope than the supplementary writedown procedure Thor applied to 9 categories of its inventory at two plants where usage records were inadequate. See Pet.Br. 9-10. Thor's supplementary procedure was endorsed by the accounting experts as also conforming to generally accepted accounting principles (Pet.Br. 13).

The reasonableness and accuracy of Thor's formula were confirmed on a seven-year hindsight basis by the testimony of five accounting experts, and of Thor's independent public accountants who had done a special study of the excess inventory procedures when they were first engaged in 1970. Among the numerous facts recited by the experts in reaching their unanimous conclusion was that more than 78% of the 1964 excess inventory had been scrapped by 1971 (see Pet.Br. 10).

Clearly, Thor's excess inventory procedures are not a "reserve for price changes or an estimated depreciation in the value" of inventory within the intended meaning of § 1.471-2 (b)(1), but are objective and reliable procedures designed to determine an existing loss due to excess inventory. If the Commissioner can properly reject Thor's excess inventory procedures as not clearly reflecting income, he effectively has the discretion to reject any such procedures.

(ii) Thor's writedown did not constitute "[t]aking . . . parts of the inventory, at a nominal price or at less than its proper value" as prohibited by § 1.471-2(f)(2). Indeed, the accounting experts established that if Thor had failed to write down the excess stock, its inventory would have been carried at *more*, not less, than its proper value (see Pet. Br. 12-13, 55).[24] Respondent argues (Resp.Br. 44) that "with respect to parts offered and *sold* at unreduced prices, it is plain that petitioner's greatly reduced inventory prices were 'nominal' or 'less than . . . proper value'" (emphasis added). This observation seemingly is off the point because Thor did not write down parts it expected to sell, but only those it anticipated could not be sold. If Respondent is objecting to the fact that Thor's estimate of the unsalable portion of a particular item may

24. In *George Ringler & Co.*, 10 B.T.A. 1134, 1137 (1928), the Board of Tax Appeals permitted the taxpayer to write down beer to salvage value when Prohibition became effective, stating:

> "To require that the goods be returned at cost or on some theoretical market price in excess of its known value would amount to writing into the inventory a value that did not, in fact, exist, and distort the income."

turn out to be too high, the formula automatically adjusts each year to maintain the inventory as closely as possible to correct value (Pet.Br. 9n). The Tax Court has expressly held that the later sale at higher prices of goods written down is not within the scope of § 1.471-2(f)(2). *Ernest, Holdeman & Collet, Inc.*, 19 T.C.M.(CCH) 43, 50, P-H TC Mem.Dec. 60-45, 60-54 (1960), *aff'd on other grounds*, 290 F.2d 3 (7th Cir. 1961), cited with approval in *Space Controls, Inc.* v. *Commissioner*, *supra*, 322 F.2d at 152.

In any event, perfect accuracy in the valuation of inventories is impossible, and Thor should be entitled to the leeway accorded by the "Cohan Rule" formulated by Judge Learned Hand in *Cohan* v. *Commissioner*, 39 F.2d 540, 543-44 (2d Cir. 1930). This rule embodies the realism that "[a]bsolute certainty . . . is usually impossible and is not necessary. . . . It is not fatal that the result will inevitably be speculative; many important decisions must be such." This principle has been applied to a variety of valuation situations, *e.g.*, *Bankers Trust Co.* v. *Higgins*, 136 F.2d 477, 479 (2d Cir. 1943) (certainty not required in predicting income for estate tax valuation purposes); and *Bryant* v. *Commissioner*, 76 F.2d 103 (2d Cir. 1935) (value of real property need not be proved conclusively), including inventory valuation, *e.g.*, *All-Steel Equipment Inc.*, 54 T.C. 1749, 1764 (1970) (allocation of overhead to inventory), *aff'd in part and rev'd on other grounds*, 467 F.2d 1184 (7th Cir. 1972); *Photo-Sonics, Inc.*, 42 T.C. 926, 936 (1964), *aff'd*, 357 F.2d 656 (9th Cir. 1966) (allocation of overhead to inventory), *acq.* 1965-2 C.B. 6; and *Edgar A. Basse*, 10 T.C. 328, 341 (1948) (estimated "increase factor" to cost-of-goods-sold under LIFO method), *acq.* 1950-1 C.B. 1. The Commissioner's understandable desire for exactitude should not allow him to require taxpayers to achieve the impossible, and a reasonable and self-correcting procedure for estimating the value of excess inventory should not be equated with taking inventory "at a nominal price or less than its proper value."

(iii) Respondent also asserts (Resp.Br. 44) that because Thor wrote down items in excess of two years' anticipated supply by 100%, but continued to offer them for sale at unreduced prices, the procedure had the effect of "[o]mitting portions of the stock on hand" prohibited by § 1.471-2(f)(3). This is no more than a variation of the argument that worthless inventory cannot be written down before it is scrapped, and would prohibit the writedown of any worthless inventory, including obsolete inventory, if the taxpayer continues to hold it for sale. Respondent's interpretation would make § 1.471-2(b)(3) inconsistent with the subnormal goods Regulation, § 1.471-2(c), which by its terms does not require a taxpayer to cease trying to sell worthless goods as a condition to writing them down. This interpretation of § 1.471-2(f)(3) also is contrary to the anti-scrapping cases, discussed *infra* at 28, which have uniformly rejected the Commissioner's argument that worthless inventory must be scrapped as a prerequisite to writing it down.

Realistically interpreted, the prohibition against omitting portions of stock on hand can apply only to inventory which has value.

2. *Sections 1.471-4 and 1.471-2(c) Should Be Construed to Be Consistent With the Purposes of § 471 of the Code.* Respondent's analysis (Resp.Br. 45-53) of the market value (§ 1.471-4) and the subnormal goods (§ 1.471-2(c)) Regulations establish—as Thor already conceded in its initial brief (Pet.Br. 64)—that Thor's writedown of excess inventory does not literally conform to the detailed mechanical requirements of these Regulations. But Respondent's selective construction does not at all establish that Thor's writedowns are prohibited by these Regulations—if they are construed to be consistent with the requirement of § 471 that inventory procedures must constitute the best accounting practice.

In construing § 1.471-4(b), Respondent gives no effect to the broad language that ". . . the taxpayer must use such evidence

of a fair market price at the date or dates nearest the inventory *as may be available* . . ." (emphasis added). In fact, in quoting that Regulation, Respondent omits the emphasized phrase (Resp. Br. 51). Instead, Respondent upgrades what are intended to be evidentiary rules for determining fair market price, to absolute prerequisites for a writedown (see, *e.g.*, Resp.Br. 51-53).

In like vein, Respondent's construction of § 1.471-2(c) stresses the rule that to be written down, goods must be offered for sale at a reduced price within 30 days of the inventory date, which the courts have refused to apply when, as here, it is impractical to do so. See Pet.Br. 68 and cases cited therein. Respondent's construction simultaneously wholly overlooks the topic sentence of that Regulation, which authorizes writedowns for "[a]ny goods in an inventory which are unsalable at normal prices . . . ." See discussion at Pet.Br. 67-68.

Section 1.471-2(b) provides that a taxpayer's inventory accounting be "substantially in accord" with the detailed Regulations. In a number of early cases, at which time the development of sound inventory rules was of preeminent concern, courts approved inventory procedures if they constituted reasonable efforts by the taxpayer to fairly value its inventory, even though those procedures did not conform to the precise requirements of the Regulations.

Thus, in *S. G. Sample Co.* v. *Commissioner, supra,* 23 F.2d at 672, the Fifth Circuit refused to require a taxpayer to individually identify the estimated market value of each item in the inventory.[25] To the same effect is *Wood & Ewer Co.* v. *Ham,* 14 F.2d 995 (D. Maine 1926), in which the court noted that Article 1582 of Regulations 45 required—as § 1.471-4(c) continues to require—valuation on an item-by-item basis, but allowed the taxpayer to value portions of inventory by department. The court stated that the purpose of the Regulations was to give the Bureau of Internal Revenue an opportunity to examine the inventory in detail, but not to absolutely require that market

25. See also the cases cited *supra* at 20 n.22.

value be assigned to each item. Accordingly, it held that the taxpayer had "made a substantial compliance with the law and with the regulation." *Id.* at 997.

Wilson Furniture Co., 10 B.T.A. 1294 (1928), has direct applicability to the instant case. There a furniture dealer wrote off out-of-style and damaged "dead stock", but continued to offer it for sale. When any of these items were sold, the entire price was entered into income. Although the Board found that the taxpayer's procedures did not comply with the requirement of the Regulations that "unsalable merchandise should be inventoried at bona fide selling price less cost of selling", the court upheld the taxpayer because "[i]t is clear that the income for the taxable year . . . is substantially accurate. . . ." *Id.* at 1296.

Of particular interest is a decision of the Sixth Circuit, *Rookwood Pottery Co.* v. *Commissioner*, 45 F.2d 43 (6th Cir. 1930), where the taxpayer used ratios of average annual cost to selling price in an effort to reconstruct the cost of returned consignment merchandise, because actual cost data could not be assigned to these goods. The Commissioner disallowed the taxpayer's valuation procedure and substituted a formula of his own. The Sixth Circuit stated, 45 F.2d at 46, that the issue "as between [the] two methods is: which more truly reflects the income?" Recognizing that "income many times cannot be accurately stated . . . [but] can only be, in the language of the statute, 'reflected,'" the court found that the taxpayer's method gave "the truer reflection," concluding, *ibid*:

> "The method presents an intelligible and fairly logical, and probably an approximately correct, result. It was doubtless adopted in good faith by the taxpayer in an effort to get at the best method of representing the truth to its stockholders, and it should not be discarded unless it is essentially wrong—not merely because it may not be exactly right."

This is resonant of the Cohan Rule, *supra* at 23, formulated that same year.

*   *   *

These cases all interpret the Regulations by practical, common sense standards directed to the ultimate question of whether the taxpayer's inventory procedures meet the statutory requirements of clearly reflecting income and constituting the best accounting practice. In sharp contrast is Respondent's construction of the detailed provisions of the Regulations which would prohibit an inventory procedure which fulfills both statutory standards.

3. *Realization of Inventory Losses is Not Required For Taxpayers Using the Lower-of-Cost-or-Market Basis of Valuation.* Respondent justifies its narrow construction of the Regulations by introducing into inventory accounting the concept that losses must be realized as a condition to any writedown for tax purposes (Resp.Br. 57):

> "Indeed, to permit petitioner's claimed inventory writedown would violate the fundamental principle of our income tax system that a deductible loss must be established by a closed and completed transaction, fixed by identifiable events, and not by fluctuations in value. . . ."

Under this theory, the lower-of-cost-or-market valuation basis, as an exception to the requirement of realization, should be strictly construed to require a taxpayer with excess inventory to either scrap the merchandise or reduce its offering price (Resp. Br. 48, 58).

If realization is required for writedowns of excess inventory, which the law has never heretofore required, the explicit requirement of § 471 that the taxpayer's inventory be valued according to the best accounting practice cannot be fulfilled because the scrapping rule does not conform to generally accepted accounting principles (see discussion *supra* at 3, 10 and Pet.Br. 55-56, 60).

Quite apart from its inherent conflict with the statute, this theory is a radical departure from judicial and administrative precedent governing inventory writedowns. The theory elevates evidentiary requirements of the inventory Regulations to

absolute rules of law, even though the courts generally have rejected that attempt (see discussion *supra* at 25-26). And, most fundamentally, it confuses the concept of "income and loss" with that of "realization".

Respondent cites no case law supporting his thesis; those cited in the Seventh Circuit opinion on this point are inapposite (Pet. A-46—A-47). This very proposition was explicitly rejected by the Fifth Circuit in *Space Controls, Inc.* v. *Commissioner, supra,* 322 F.2d at 148.

Of particular relevance are a number of cases which have criticized and rejected the contention of the Commissioner that worthless inventory must be scrapped to be written off. *C-O-Two Fire Equip. Co.* v. *Commissioner,* 219 F.2d 57, 59 (3rd Cir. 1955), held that an effort to sell obsolete goods did not preclude its writeoff. In *Templeton, Kenly & Co.,* 6 B.T.A. 61, 67 (1927), *acq.* X-1 C.B. 64 (1931), the Board held that scrapping was "merely evidentiary" and had no bearing upon the value of the closing inventory. *Ernest, Holdeman & Collet, Inc.,* 19 T.C.M. (CCH) 42, 51, P-H TC Mem.Dec. 60-43, 60-54 (1960), cited with approval in *Space Controls, Inc.* v. *Commissioner, supra,* 322 F.2d at 152, equated realization with the writeoff rather than physical scrapping:

> ". . . [P]etitioner valued its inventory at lower of cost or market. . . . When it became apparent that the going market value of a particular machine was less than petitioner's cost basis, the inventory valuation was reduced to accord with market. . . . This procedure properly resulted in the realization of a loss when it occurred—the year the machine became worthless, not necessarily the year the machine was physically cast upon the scrap pile."

See also *McKay Machine Co.,* 28 T.C. 185, 194 (1957).

Respondent's theory also is inconsistent with numerous provisions of the inventory Regulations governing other inventory methods which permit the writedown of unrealized losses, *e.g.,* § 1.471-6(d) (farm-price method); § 1.471-6(e) (unit-livestock-price method); and § 1.471-8(a) (retail inventory method).

One of the landmark early rulings on inventory concepts by the Treasury Advisory Tax Board, T.B.R. 48, 1 C.B. 47, 49-50 (1919), made it clear that realization is not required for taxpayers using the lower-of-cost-or-market valuation basis because that would be unsound in principle:

> ". . . A loss may be occasioned by physical destruction or deterioration of property included in an inventory or it may be attributable to changes in styles or other causes affecting salability, or it may be occasioned by shrinkage in market value. Where such losses arise, even though not fully consummated by a sale of the goods, the fact should nevertheless be recognized, and when such goods are taken in an inventory they may, if the taxpayer so elects as a consistent policy, be valued at market instead of cost, where market is lower. This is true even in spite of the possibility that conditions may change, and at a date before a sale is made the goods may again be worth their original cost. . . . In a very real sense losses may be admitted, while profits must be proved. Capital once impaired is gone, but the admission of a loss not fully realized by a completed transaction results in nothing more serious than a postponement of profit to a subsequent period. . . . The rule of cost or market, whichever is lower, even though it may appear to lack in consistency, thus, nevertheless, rests upon solid ground, and its widespread adoption throughout the business world amply justified its adoption for tax purposes."

Interpretations shortly after enactment of a law, as Mr. Justice Cardozo observed, have ". . . peculiar weight when it involves a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new." *Norwegian Nitrogen Prod. Co.* v. *United States,* 288 U.S. 294, 315 (1933).

Respondent's theory in effect incorporates realization into the definition of income. This is untrue generally for tax accounting —for example the accrual of income and expense, and the doctrine of constructive receipt—and it has never been true for inventory accounting. The distinction has never been better

illuminated than in Henry J. Simons, Personal Income Taxation 84 (1938):

> "One realizes on assets; one converts assets from one form into another; and one may 'realize' cash, potatoes, or chicken pox. But gain simply is not something which may be delivered at one's doorstep. One may gain without realizing and realize without gaining; and if either is essential to the existence of income, the other must be excluded. Common sense and established usage suggest that gain is the true *sine qua non;* but much of the current discussion of the income concept, especially by the courts, may be regarded as emphasizing realization to the exclusion of gain."

Section 471 requires that inventories clearly reflect "income", not "realized income". Inasmuch as Congress has been aware for almost 60 years that inventory losses could be recognized without realization, one must assume that it intended, in the many reenactments of § 471, the statute to mean what it says.

Respondent's effort to require realization for excess inventory losses seemingly is founded on the fear that anything less "objective" will engender tax avoidance through taxpayer manipulation of inventory values from year to year (Resp.Br. 58). In truth, a writeoff system such as Thor's, objectively based on actual sales, computed on an item-by-item basis, self-correcting, and subject to annual review by independent auditors, is largely immune to taxpayer manipulation. The scrapping rule is not, because the inventory already will have been written off for financial accounting purposes, so the taxpayer will be free (subject to his business needs for spare parts) to choose the years in which scrapping losses will yield the greatest tax benefit. This freedom will be particularly beneficial to taxpayers subject to progressive tax rates—*e.g.*, all businesses conducted as proprietorships, partnerships and subchapter S corporations, as well as all corporations whose annual income regularly or occasionally is less than $100,000,[26] comprising

26. Corporate tax rates are progressive under current law to $50,000 and will be steeply progressive to $100,000 under the recently enacted Revenue Act of 1978.

over 99.5% of all businesses[27]—who will scrap in high income years.

D. The Non-Inventory Accounting Cases Are Not Authority for Determining Whether or Not Thor's Inventory Procedures Were Proper Under § 471

Respondent concludes its principal argument by accurately observing that this Court has held that generally accepted commercial accounting principles do not necessarily govern computation of taxable income, particularly as to reserves for future expenses and the deferral of income, which are customarily permitted, and even required, under generally accepted accounting principles (Resp.Br. 58-65). Respondent goes on to inaccurately characterize Thor's excess inventory writedown as "estimates of an anticipated loss [which] is nothing more than a reserve to cover a contingency that may arise in the future" (Resp.Br. 62). As has been shown, *supra* at 6-7, that factual characterization is contrary to the finding of the Tax Court, based on the unanimous testimony of the expert accounting witnesses, that the writedown recognized a currently existing loss, not a future one.

As Thor's initial brief demonstrated (Pet.Br. 45-48), the prepaid income and the expense reserve cases are not applicable to inventory accounting, and, until the decisions below, have never been so viewed. This derives not only from conceptual differences already discussed, *supra* at 28-30, but also from statutory and constitutional distinctions established during the earliest days of the income tax.

Since the Revenue Act of 1918, inventories have been governed by § 471 and its predecessors, which require not only that they clearly reflect income but that they constitute a best accounting practice. Except for the general rule of § 446, there is no equivalent provision for other prepaid income and reserves for future expenses, the absence of which is dramatized by the

27. Internal Revenue Service, Statistics of Income—1973, Corporation Income Tax Returns 128 (1977).

short-lived existence of §§ 452 and 462 which provided for them (see Pet.Br. 46, 47n).[28]

The special dependence of § 471 upon financial accounting standards, expressed in the term "best accounting practice", may in part be due to the fact that cost-of-goods-sold—which depends on opening and closing inventory values—must be taken into account in calculating gross income under the Sixteenth Amendment. See Tax Court's opinion (Pet. A-17). In *Lela Sullenger*, 11 T.C. 1076, 1077 (1948), *appeal dismissed* (5th Cir. 1950), *nonacq.* 1949-1 C.B. 6, *acq.* 1952-2 C.B. 3, *nonacq.* 1976-1 C.B. 1, the Tax Court stated:

> "Section 23 [now § 61] makes no provision for the cost of goods sold, but the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory."

Thus, in contrast to all other deductions which are discretionary with the legislature, *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934), a taxpayer is entitled to have his cost-of-goods-sold determined through a correct valuation of his opening and closing inventory.

E. Section 446(e), Which Requires the Prior Consent of the Commissioner for a Taxpayer to Change Its Method of Accounting, Is Not Applicable to Thor's Writedown of Excess Inventory

Respondent contends, as an alternative ground for affirmance, that Thor changed its method of accounting in 1964 without

28. It should be recalled that these sections were repealed not as a matter of tax accounting principle, but because of the large and unexpected revenue loss during the transition period when taxable income was being deferred pursuant to § 452 and expense accrual accelerated under § 462. See H.R. Rep. No. 293, 84th Cong., 1st Sess. 3-4 (1955); S. Rep. No. 372, 84th Cong., 1st Sess. 3-5 (1955).

obtaining the prior consent of the Commissioner required by § 446(e), which provides:

> ". . . a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate."

Because the statutory notice of deficiency (A3) did not assert that Thor had changed its method of accounting, the Tax Court properly ruled, prior to trial, pursuant to Rule 32 of the Tax Court (now Rule 142), and reiterated at the outset of trial (A30-A32), that the burden of proof on this issue affirmatively was on the Commissioner.[29] Inasmuch as the Tax Court reached no decision on this complex issue, at most it should be grounds for remand. See *Aetna Casualty & Surety Co.* v. *Flowers*, 330 U.S. 464, 468 (1947); *United States* v. *Ballard*, 322 U.S. 78, 88 (1944).

In any event, this is a phantom issue. Even if it were assumed that Thor changed its excess inventory valuation procedures at the end of 1964, which the Commissioner did not prove, and if it were further assumed that the supposed change constituted a change in Thor's "method of accounting," which it did not, the change in Thor's procedures cannot cause any income of Thor to be omitted or cause any double increase in its cost-of-goods-sold. Both § 446(e), upon which Respondent relies, and its companion enactment § 481, establish that the statutory purpose is to "prevent amounts [of taxable income] from being duplicated or omitted." See discussion *infra* at 42-44.

If Thor did change its method of accounting, it would be required to resume its pre-1964 procedure for valuing excess inventory.[30] The only possible differences between the "old"

29. Respondent acknowledges this burden of proof at p. 10 n.11 of his brief, but does not mention it in his argument at pp. 65-71.

30. To illustrate, the issue whether Thor changed its method of accounting is of independent significance only if this Court holds that Thor's 1964 inventory procedures clearly reflect income, since a contrary holding would be sufficient to sustain the lower court's

(Footnote continued on next page)

procedures and those used by Thor in 1964 is ***how much*** excess inventory would be written off in 1964 and how much in each year thereafter. The *total* amount written off will not be affected by which procedure is used. Thus, there is no potentiality for the omission of income or of a double deduction (*i.e.*, a double increase in Thor's cost-of-goods-sold), which means that any change in Thor's excess inventory procedures simply is outside the scope of § 446(e).

1. *The 1970 Amendments to Regulations § 1.446-1(e) Are Not Properly Applicable to Thor's 1964 Tax Year.* The question whether Thor changed its method of accounting in 1964 is subject to the preliminary issue of whether a 1970 amendment to the Regulation can affect the 1964 tax year. Respondent relies upon Regulation § 1.446-1(e), as amended by T.D. 7073 (filed November 17, 1970), 1970-2 C.B. 98, which substantially expanded the definition of what constitutes a change in a "method of accounting" by enlarging the subordinate concept of what is a change in the treatment of a material item.[31] See detailed discussion *infra* at 41. Apparently Respondent believes the amendment to be retroactively effective for all taxable years

(Footnote continued from preceding page.)

decision. If this Court does hold that Thor's 1964 inventory procedures clearly reflect income, and if on remand the Tax Court determines that Thor changed its method of accounting, then the only option open to that court is to require Thor to resume its pre-1964 procedure for valuing excess inventory. Thor could not be required to keep worthless inventory on the books at full cost, since that would conflict with the holding of this Court that Thor's inventory write-down procedures clearly reflected income. Under § 446(b), the Commissioner cannot substitute a method of accounting for one which clearly reflects income. *Thompson-King-Tate, Inc.* v. *United States,* 296 F.2d 290, 294-95 (6th Cir. 1961).

31. Before 1970, Regulation § 1.446-1(e)(2)(ii) illustrated a change requiring the Commissioner's consent to be "a change involving the *method or basis* used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder) . . ." (emphasis added).

After the amendment, § 1.446-1(e)(2)(ii)(c) defined a change requiring consent to include:

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commencing on or after January 1, 1954.[32] No doubt Respondent relies on § 7805(b), which embodies the extraordinary concept—not generally applicable to regulations of other agencies—that all Treasury Regulations and their amendments are retroactive unless otherwise specified by the Secretary. Notwithstanding that rule, this Court has not permitted amendments to Regulations to have retroactive effect where the amendment was not remedying a mistake of law and where the taxpayer could not reasonably have anticipated the change. *Central Illinois Public Service Co.* v. *United States,* 435 U.S. 21, 32 (1978); *Helvering* v. *Griffiths,* 318 U.S. 371, 402-403 (1943);[33] *cf. Helvering* v. *R. J. Reynolds Tobacco Co.,* 306 U.S. 110, 115-117 (1939). Indeed, the courts below followed *Reynolds Tobacco* to hold in this very case that the 1973 amendment to § 1.471-2(b) was not retroactively effective to 1964 (Pet. A-22, A-39 n.11). See Thor's initial brief (Pet.Br. 32n).

(Footnote continued from preceding page.)

> "A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material items used in the overall plan for identifying or valuing items in inventory is a change in method of accounting."

32. This is not asserted in the argument portion of Respondent's brief, which cites and quotes from the amended Regulation without identifying the 1970 amendments. In the Appendix to its brief (p. 84), Respondent states that the amendment is retroactive.

33. "We are asked to make a retroactive holding that for some seven years past a multitude of transactions have been taxable although there was no source of law from which the most cautious taxpayer could have learned of the liability. If he consulted the decisions of this Court, he learned that no such tax could be imposed; if he read the Delphic language of the Act in connection with existing decisions, it, too, assured him there was no intent to tax; if he followed the Congressional proceedings and debates, his understanding of nontaxability would be confirmed; if he asked the tax collector himself, he was bound by the Regulations of the Treasury to advise that no such liability existed. It would be a pity if taxpayers could not rely on this concurrent assurance from all three branches of the Government. But we are asked to brush all this aside and simply to decree that these transactions are taxable anyway." 318 U.S. at 402.

There are persuasive reasons for denying retroactivity to the 1970 amendment of § 1.446-1(e). When Thor was valuing its inventory near the end of 1964, even if it had suspected that it might be making a change in its method of accounting for tax purposes, it would have found nothing in then-existing § 1.446-1(e) even hinting that its year-end valuation procedures might constitute a change of its inventory *method* (FIFO and standard costs) or of its *basis* of inventory valuation (lower-of-cost-or-market), requiring the consent of the Commissioner. See § 1.446-1(e)(2)(ii) quoted *supra* at 34 n.31. Case research would have unearthed not a single decision suggesting the possibility. Research might have discovered a well-publicized 1961 letter from the Commissioner to the Committee on Federal Taxation of the A.I.C.P.A. stating that the tentative view of the Internal Revenue Service was that "the classification of stock as unsalable at normal prices without regard to the requirements of section 1.471-2(c) of the Regulations" was not a change of "method" requiring consent (but was an "error" that did not require consent). This letter is excerpted in Patton, *Inventory Procedures: Recent Developments in Internal Revenue Service's Attitude,* 23 N.Y.U. Institute on Federal Taxation 839, 844-45 (1965). These facts are reminiscent of those recited in *Griffiths,* quoted *supra* at 35 n.33.

Notwithstanding what was known or knowable by Thor in 1964, Respondent now seemingly assumes that Thor should have anticipated the 1970 amendments and filed a request with the Commissioner in 1964 to change its method of accounting. One can imagine Thor's request reading "In the event that future amendments to the Regulations ever retroactively make the proposed inventory procedures a change in accounting method, permission is hereby contingently requested for such a change." How would the Commissioner respond to such a request? To paraphrase the opinion of this Court in *Central Illinois Public Service Co., supra,* 435 U.S. at 32: no taxpayer, in viewing the Regulations in 1964, could reasonably suspect that a consent

obligation existed. See also 435 U.S. at 38 (Powell, J. concurring).

2. *If Thor Instituted Any Change in Its Procedure for Valuing Excess Inventory in 1964, It Did Not Constitute a Change in a Method of Accounting Within the Meaning of § 446(e).* There are three prerequisites to the application of § 446(e):

(i) the change by the taxpayer must be of a "method of accounting",

(ii) that causes income to be omitted or the same expense to be deducted twice, and

(iii) which is not merely a correction of mathematical or posting errors, an erroneous application of the taxpayer's accounting method, or a response to a change in the underlying facts.

The alleged changes by Thor of its inventory valuation procedures in 1964 do not meet any of these three requirements, as shown in (i), (ii), and (iii) below.

(i) Section 446(e) provides:

> ". . . a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate."

The statute does not refer to a "change in the treatment of a material item". This concept derives from the Committee Reports accompanying § 446(e):[34]

> "Subsection (e) codifies existing regulations. A change in the method of accounting includes a change in the

34. Section 446(e) was a codification of Regulations 118, § 39.41-2(c) which trace back to Regulations 45, Article 23, as amended by T.D. 2873, 1 C.B. 58 (1919). Prior to the 1954 Code, the Regulations did not refer to a "change in the treatment of a material item" because until then hybrid methods of accounting were prohibited, *e.g., Massachusetts Mutual Life Insurance Co.* v. *United States,* 288 U.S. 269, 273-74 (1933); *United States* v. *Anderson,* 269 U.S. 422, 440 (1926).

general method of accounting such as a change from the cash receipts and disbursements method to an accrual method, or vice versa, or a change from the cash or an accrual method to the long-term contract method, or vice versa. It also includes a change in the treatment of a *material item* such as a change in the *method* of valuing inventory, or a change from an accrual method without estimating expenses to an accrual method with estimated expenses, or vice versa, or a change in the method of depreciating any property. *A change in the method of accounting is a substantial change as distinguished for* [sic] *each change in the treatment of each item.*" (Emphasis added.) H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A158 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 300 (1954).

This excerpt discloses that Congress intended § 446(e) to apply only to substantial accounting changes adopted by a taxpayer. There is no suggestion of a Congressional intention to inhibit the flexibility of taxpayers to improve their accounting procedures or to alter them to meet new or changing conditions. This policy has a practical administrative benefit to the Commissioner by limiting requests for accounting changes to major matters.

One type of substantial change is, in the words of the Reports quoted above "a change in the method of valuing inventory". This language was expanded moderately by the initial Regulation § 1.446-1(e), promulgated in 1957 by T.D. 6282 (filed December 25, 1957), 1958-1 C.B. 215, which listed as an example of a change requiring the Commissioner's consent ". . . a change involving the *method or basis* used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder). . ." (emphasis added).[35] The terms "method" and "basis" had at that time, as now, a definite and established meaning.

35. Regulation § 1.446-1(e)(2) then defined and illustrated the changes requiring consent as follows:

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Section 1.471-2(c) of the Regulations defines "basis of valuation" as "cost" and "cost or market, whichever is lower". "Method" is a more generic term and includes the LIFO method (I.R.C. § 472 and § 1.472-1(a) of the Regulations thereunder), farm-price method (§ 1.471-6(d)), unit-livestock-price method (§ 1.471-6(e)), and retail price method (§ 1.471-8), as well as cost accounting systems such as the full absorption method (§ 1.471-11(a)), the manufacturing burden rate method (§ 1.471-11(d)(2)), and the standard cost method (§ 1.471-11(d)(3)). Thus, the Committee Reports and the initial Regulation interpreting them limited the definition of a change in the "treatment of a material item" in inventory accounting to a change in an inventory "method" or a change in the "basis" for valuing inventory. There is no evidence of any intention to require the Commissioner's consent for a change in the subordinate procedural details of an inventory method or valuation basis. This limited definition is wholly consistent with the explicit statement in the Committee Reports that § 446(e) is intended to encompass only "a substantial change as distinguished for [sic] each change in the treatment of each item." See passage quoted *supra* at 37-38.

(Footnote continued from preceding page.)

"(i) . . . A change in the method of accounting includes a change in the overall method of accounting for gross income or deductions, or a change in the treatment of a material item. . . ."

"(ii) Examples of changes requiring consent are: A change from the cash receipts and disbursements method to an accrual method, or vice versa; a *change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder)*; a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451-3); a change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income, such as the crop method; or a change in the treatment of any other items of income or expense, where material." (Emphasis added.)

The foregoing was not changed by amendments to this Regulation effected by T.D. 6584 (filed December 21, 1961), 1962-1 C.B. 67.

There appears to be only one reported case in which the Commissioner has argued that a change of a material item that is a component of an established inventory method constituted a change in a method of accounting. His assertion was rejected by the Tenth Circuit in *Monfort of Colorado, Inc.* v. *United States*, 561 F.2d 190 (10th Cir. 1977), *aff'g* 406 F.Supp. 701(D.Colo. 1976), which held that a change by the taxpayer *from* treating hedging gains and losses as income *to* adjusting ending inventory by such gains and losses did not constitute a change in the taxpayer's method of accounting. The Tenth Circuit quoted with approval the District Court's conclusion that ". . . it seems clear that the kind of change in accounting method requiring the Commissioner's prior consent is a change in the basic method of reporting and not in the treatment of specific items." *Id.* at 197.[36]

Thor did not change either the "method or basis" for valuing its inventories in 1964. It continued, as it had in previous years, to use the FIFO with standard cost method, and the lower-of-cost-or-market basis for valuing its inventories. Subordinate to its method and basis of valuation, Thor continued, as it always had, to write off inventory when Thor's management concluded that it was worthless.[37]

36. None of the cases cited by Respondent involved a change in either inventory method or procedures: *Commissioner* v. *O. Liquidating Corp.*, 292 F.2d 225 (3rd Cir. 1961) (change from accrual to cash receipts method for reporting dividends received from a mutual insurance company); *American Can Co.* v. *Commissioner*, 317 F.2d 604 (2d Cir. 1963) (change from cash receipts to accrual method for deducting taxes and vacation pay); *Wright Contracting Co.* v. *Commissioner*, 316 F. 2d 249 (5th Cir. 1963) (partial change from accrual to completed contract method); *Peoples Bank & Trust Co.* v. *Commissioner*, 415 F.2d 1341 (7th Cir. 1969) (improper accrual of interest expense which the Commissioner required to be discontinued).

37. The distinction between an inventory method and an underlying procedural component of it is well-illustrated by Rev. Rul. 75-445, 1975-2 C. B. 74, involving the valuation of accounts receivable. The Ruling held that a bank which used the reserve method for calculating its bad debts under § 166(c) could change its procedures

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Respondent in effect argues (Resp.Br. 67-68) that the concept of material item in inventory accounting is governed by the 1970 amendments to the Regulation, notwithstanding that they were issued six years after the tax year in question. See discussion *supra* at 34-37. Section 1.446-1(e)(2)(ii)(c), as amended, provides:

> "A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting."

The second sentence is not based on any statutory language, but conflicts with the plain legislative intention (discussed *supra* at 37-38). It is not derived from any judicial authority. This is a classic example of what this Court described in *Central Illinois Public Service Co., supra*, 435 U.S. at 31 (1978), as a "narrow and precise" standard established by Congress which "administrative and other pressures seek to soften and stretch."[38]

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for calculating the reserve from the "percentage method" to the "experience method" without consent of the Commissioner because neither valuation procedure was a method of accounting within the meaning of § 1.446-1(c). The "reserve method" itself was held to be the method of accounting. By analogy, Thor's inventory method is FIFO and standard costs with the lower-of-cost-or-market valuation basis, and its excess inventory procedures are equivalent to the underlying percentage and experience methods for calculating the bad debt reserve.

38. Examples 7 and 8 of the 1970 version of § 1.446-1(e)(2)(iii), cited at Resp.Br. 68 n.31, are distinguishable by the fact that they illustrate changes of a valuation "basis" and the base stock "method" respectively.

Of more relevance is Example 9 of the proposed amendments to the Regulation, see Notice of Proposed Rulemaking, 33 Fed. Reg. 18936, 18937 (1968), which is given as an example of a change in an inventory method:

> "A taxpayer values inventories on the basis of cost or market, whichever is lower. This value has been consistently and systematically written down for estimated obsolescence. Although such

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(ii) The general comments on the accounting provisions of the 1954 Code in both the House and Senate Committee Reports could not be more explicit as to the purpose of § 446(e):

> "The changes embodied in your committee's bill are designed to bring the income-tax provisions of the law into harmony with generally accepted accounting principles, and to assure that *all items of income and deductions are taken into account once, but only once, in the computation of taxable income.*" (Emphasis added.) H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 48 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 62 (1954)[39]

The Treasury Regulations have been faithful to this purpose. In 1964, § 1.446-1(e)(3) provided:

> "The taxpayer shall, to the extent applicable, furnish all information . . . disclosing in detail all classes of items which would be treated differently under the new method of accounting and showing all amounts which would be *duplicated or omitted* as a result of the proposed change." (Emphasis added.)

This interpretation of the Congressional intent is reinforced by the language of § 481, which first appeared in the 1954 Code as a companion to § 446(e). Section 481 is designed to protect against income being omitted or deductions duplicated if either a taxpayer made an unauthorized change in his method of accounting, or the Commissioner required a taxpayer, pursuant to § 446(b), to change an incorrect method of accounting which did not clearly reflect income. When the Commissioner compelled such a change, pre-1954 case law usually would permit

(Footnote continued from preceding page.)

> writedowns are improper treatments of a material item used within the framework of the overall plan, a change to eliminate the use of this practice is a change of method of accounting for inventories."

The unexplained deletion of this Example from the final amendments to the Regulation implies that the Treasury drafters concluded that it did not illustrate a change in a method of accounting.

39. The emphasized language is also directed to § 481.

the omission of income or a double deduction caused thereby. To correct this and create symmetry between voluntary taxpayer and Commissioner induced changes, § 481(a)(2) provides that:

> "There shall be taken into account those adjustments which are determined to be necessary solely by reason of the change [in a method of accounting] in order to prevent amounts [of income and expense] from being duplicated or omitted. . . ."

The discussion of § 481 in both the House and Senate Committee Reports stated:

> "Adjustments Required By Changes In Method Of Accounting. If there is a change in the method of accounting employed in computing taxable income from the method employed for the preceding taxable year, adjustments must be made in order that every item of gross income or deduction is taken into account and that none are omitted. At the same time no item is to affect the computation of taxable income more than once. It is only those omissions or doubling ups which are due to the change in method which must be adjusted." See H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A164 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 307 (1954).

The Congressional purpose is clearly embodied in the Regulations interpreting § 481, *e.g.*, § 1.481-1(a)(1), (b), and § 1.481-2(d), *Example (1).*

The commonality of purpose between § 446(e) and § 481 is demonstrated by the fact that they are both triggered by a change in a "method of accounting". The use of this term in § 446(e) shows that the purpose of that section is to enable the Commissioner to review proposed changes to determine whether they will result in an omission of income or a doubling of deductions.[40]

40. Thor can find no case which discusses this clear statutory requirement of §§ 446(e) and 481. See *Hackensack Water Co.* v. *United States*, 352 F.2d 807, 810 (Ct. Cl. 1965), discussing this requirement under pre-1954 regulations.

Respondent does not allege that any changes in Thor's procedures resulted, or even had the potentiality to result, in income escaping taxation or in a double deduction (*i.e.*, double increase in cost-of-goods-sold). Depending on one's viewpoint, Thor's 1964 valuation procedures resulted in a belated writeoff in 1964 of valueless inventory, some of which should have been written off in earlier years (as Respondent alternatively asserts); constituted a correct writeoff in 1964 (as Thor argues); or accelerated a writeoff belonging in future years (as Respondent primarily contends). A change between any of these alternatives, however, can result in any income escaping tax or in a double increase in cost-of-goods-sold, and therefore even if there were a change in Thor's excess inventory valuation procedures in 1964, it was outside the scope of § 446(e).

(iii) Excluded from the definition of a change of a method of accounting are the correction of mathematical or posting errors, an erroneous application of the taxpayer's accounting method, and a response to a change in underlying facts.[41] See *W. A. Holt Co.* v. *United States*, 368 F.2d 311 (5th Cir. 1966) (writeoff of accounts receivable which were not worthless was an improper deduction rather than a method of accounting); *Korn Industries, Inc.* v. *United States*, 532 F.2d 1352, 1355-56 (Ct. Cl. 1976), *nonacq*. Rev. Rul. 77-134, 1977-1 C.B. 132 (error in allocating three items of overhead not a method of accounting); and *Walter H. Potter*, 44 T.C. 159, 170-71 (1965) (improper application of cash receipts method by excluding portion of face amounts of notes received on the sale of houses not a method of accounting).

If Thor introduced new procedures for identifying and writing off excess inventory in 1964, they were a reaction to a change of circumstances, a better application of an existing method, a correction of an error in judgment made in earlier years, or

41. The first and third of these exceptions are recognized by the current Regulations. See § 1.446-1(e)(2)(ii)(b) and (c), and § 1.446-1(e)(2)(iii), *Example (4)*. The Regulations in effect in 1964 did not refer to any of these exceptions.

a mixture of all of these, rather than a change in Thor's inventory method, which continued to be FIFO with standard costs, or in its lower-of-cost-or-market valuation basis.[42]

* * *

In summary, even if Thor changed its procedures for valuing excess inventory at the end of 1964 (which the Commissioner did not establish), such procedural changes, as a matter of law, would not constitute a change in Thor's method of accounting for any one of these reasons: (i) it was not a change in Thor's inventory valuation basis or method, which respectively continued to be the lower-of-cost-or-market and FIFO with standard costs; (ii) it could not result in the omission of income or a double increase of Thor's cost-of-goods-sold; and (iii) it was at most in the nature of a correction of a previous erroneous application of Thor's accounting method or a reaction to a change in underlying facts.

3. *The Evidence Is Insufficient to Meet the Commissioner's Burden of Proof That § 446(e) Is Applicable*. In order to meet his burden of proof, the Commissioner was required to establish (i) that Thor changed its procedures for valuing excess inventory at the end of 1964; (ii) that such change resulted in the omission of income or a double increase of cost-of-goods-sold; *and* (iii) that such change constituted a "method of accounting", rather than the correction of an erroneous application of Thor's established accounting method or a reaction to changed circumstances. If the statement in Thor's tax return for 1964 is con-

42. To the extent that Thor's excess inventory writedown in 1964 fell within any of these categories, both judicial authority and the Commissioner's usual practice establish that the proper year for writeoff is 1964, when Thor determined, *as a reasonable exercise of business judgment*, that there was excess inventory (see Pet.Br. 70-71).

Alternatively, if the 1964 writedown is deemed to require an adjustment of the results of earlier years, all of the necessary adjustments in Thor's taxable income for those years can be made. The years 1961 through 1963 in effect are open pursuant to § 6214(b), and liability for years before that can be recalculated under §§ 1311 *et seq*. (see Pet.Br. 70n).

strued most favorably to the Commissioner,[43] the first of these elements may have been partially proved. The others were not. The Commissioner did not establish such threshold facts as what procedures Thor used in prior years for valuing excess inventory, what the results of those procedures were, or whether Thor in fact had excess inventory prior to 1964 that was not written off pursuant to a correct application of Thor's then valuation procedure.

To be specific, the record demonstrates that Thor adjusted closing inventory in each of the years 1960 through 1963 to write down parts for discontinued tools on a 10-year amortization basis (Stip. ¶ 6(a), A24). Otherwise the record is silent as to whether Thor employed any other procedures in 1963 and earlier years to identify the existence of excess inventory. There is no evidence whether there were any inventory writedowns, which could have been posted either directly to inventory accounts or to the reserve for inventory valuation (RIV)—or contrawise whether management reasonably determined, after analysis, that there was no excess inventory in addition to that adequately provided for by the 10-year amortization writedown.

Respondent called no witnesses to establish the necessary facts. It did not cross-examine Thor's president or other witnesses on these facts. Instead, it introduced nine exhibits, consisting principally of Thor's reports to shareholders and to the S.E.C. for 1963 to 1965, presumably on the theory that these documents contained admissions by Thor that it had changed its procedure for valuing excess inventory in 1964. These documents, excerpted in relevant part at pp. 227-263 of the Appendix, do not support Respondent's contention, much less sustain his burden of proof.

43. Thor declared on its 1964 return that its inventories:

". . . were priced at the lower of cost <first-in, first-out> or market, such inventories are stated on the same basis and were determined generally in the same manner as inventories at December 31, 1963 except that as a result of revision in operating policies made late in 1964, revised procedures were adopted to value excess stock." (Ex. 7-G, A38, A226.)

In evaluating these documents, it is necessary to be mindful that they employ terms of financial accounting, not of tax accounting. Financial accounting uses the phrase "change in generally accepted accounting principles" to mean a major change such as from accrual to cash basis or from the LIFO to the FIFO inventory method. The equivalent in tax accounting terminology is a "change in a method of accounting". In financial accounting, any change less than one of "principle" is variously designated as a change of "method," "procedure," "practice," or "technique". The equivalent terminology in tax accounting is a change in "practice" or "procedure". Thus, a change of "method" in financial accounting is a minor change not equivalent to a major change of "method" in tax accounting. See testimony of the expert accounting witnesses (A115-A119, A142-A143, A163-A166, A182-A183).

Although several of Thor's reports to its shareholders and to the S.E.C. for 1964 and 1965 stated that Thor had changed its "procedures" or "methods" for valuing obsolete and excess inventory at the end of 1964 (*e.g.*, Ex. P, A47, A227, A232; Ex. Q, A47, A235; Ex. R, A47, A245, A247-A248, all quoted at Resp.Br. 5-6, 8, 69-70), nowhere did those reports indicate that Thor had made a change of accounting *principle* as to the valuation of its inventory. This is clearly shown in Thor's amended Form 10-K to the S.E.C. for 1964 (Ex. S, A47, A249-A261). That document lists three categories of adjustments by Thor at the end of 1964 (A250-A251). Only the second category, which did not include any inventory adjustment, involved changes in the application of generally accepted accounting principles (A258-A259).

Thor confirmed this documentary evidence by questions to the expert accounting witnesses. Four of them were asked the hypothetical question: if it were assumed that Thor had used only the 10-year amortization procedure prior to 1964, and first adopted the primary and supplementary procedures in 1964, would such a change constitute a change in accounting

principle. The unanimous answer was no (A117, A143, A165-A166, A183). This, as explained above, is equivalent to stating in tax accounting terminology that Thor did not make a change in its method of accounting.

Except for the 10-year amortization writeoffs, there is no evidence in the record as to what procedure Thor used to identify and value excess inventory in 1963 and earlier years, whether it wrote off any such excess in those years, or whether it determined in those years that there was no excess.[44] But even more decisive, the Commissioner did not show that any change by Thor of its inventory valuation procedures could result in an omission of income or a double increase of its cost-of-goods-sold. The Commissioner simply did not meet his burden of proof.

* * *

For all these reasons, the allegation that Thor changed its method of accounting does not justify either an affirmance or a remand.

II.

BAD DEBT ISSUE

Respondent succeeded in briefing (Resp.Br. 71-75) the bad debt issue without once referring to Treasury Regulation § 1.166-4(b)(1) which declares that:

> "What constitutes a reasonable addition to a reserve for bad debts shall be determined in light of the facts existing at the close of the taxable year of the proposed addition."

This is in stark contrast to Respondent's treatment of the inventory issue where he principally relied on "the detailed pro-

44. This lack of evidence is not remedied by quoting out of context, as does Respondent, the puzzling observation of the Seventh Circuit (Pet.A-45) that ". . . the new management adopted a valuation method which resulted in overall write-downs of nearly $4 million in 1964, as compared with a small fraction of that amount in the preceding years" (Resp. Br. 69). The total inventory write-down of $4,000,000 due to a variety of causes (see A52-A53) has no relevance in establishing that the $927,000 writedown for excess inventory in 1964 constituted a change in Thor's accounting method.

visions of the Regulations upon which this case must ultimately turn" (Resp.Br. 38).

Although the Regulation requires examining the "facts existing at the close of the taxable year of the proposed addition," Respondent seeks to look instead both backward and forward from that date to determine the reasonableness of Thor's bad debt reserve. Respondent defends the validity of the *Black Motor* formula which looks only backward. He simultaneously stresses that Thor did not introduce evidence of eventual non-collections to prove the accuracy of its 1965 addition to its reserve for bad debts (Resp.Br. 73-74).[45]

Although Respondent expressed grave concern about the supposed ability of the taxpayer to manipulate excess inventory writeoffs, if they are not based on the scrapping rule, he does not address Thor's argument that the *Black Motor* formula is susceptible to taxpayer manipulation because it directly depends on actual bad debt writeoffs by the taxpayer (Pet.Br. 75). Moreover, no explanation is offered by Respondent why the reserve method under § 166(c) should, through use of the *Black Motor* formula as a *per se* standard, directly depend on the taxpayer actually charging debts off its books, when Congress has eliminated that requirement as a condition to deducting bad debts pursuant to the general provisions of § 166(a) (see Pet.Br. 76).

Respondent likewise bypasses any discussion of the original limited purpose of the *Black Motor* formula or of the fact that that formula is inherently arbitrary (Pet.Br. 75); coordinately, Respondent ignores the finding of the Tax Court as to the detailed account-by-account review undertaken by Thor's personnel most familiar with Thor's debtors and the sequential re-

45. These arguments are squarely inconsistent with the positions Respondent has taken on the inventory issue. Respondent vigorously objects to Thor's excess inventory writedowns even though they were based on Thor's sales and production usage experience. Thor's extensive hindsight evidence demonstrating the accuracy of its 1964 excess inventory writedown is treated by Respondent as irrelevant; in fact, that evidence was admitted over the strenuous objections of trial counsel for the Commissioner (A87, A90-A91).

view by three levels of Thor's management (Pet. A-16), *the accuracy of which has not been questioned by the Commissioner or by the courts below.*

Instead of facing any of these fundamental issues, Respondent cites cases in which courts have approved use of the *Black Motor* formula, *Atlantic Discount Co.* v. *United States*, 473 F.2d 412, 414-15 (5th Cir. 1973); *Ehlen* v. *United States*, 323 F.2d 535, 540 (Ct. Cl. 1964); and *S. W. Coe & Co.* v. *Dallman*, 216 F.2d 566, 569 (7th Cir. 1954).[46] None of them involved, as here, the refusal of the Commissioner to give any credence to the uncollectibility of specific accounts which represented $184,000 of the $229,000 balance Thor determined as necessary for its bad debt reserve in 1965. In fact, this $184,000 exceeded the $136,000 addition to Thor's reserve for that year. Inasmuch as Thor's aging procedures added relatively small amounts to its reserve (Pet.Br. 16), Respondent's argument against the validity of aging is largely irrelevant (Resp.Br. 73).

Respondent concludes by purportedly distinguishing the principal cases relied upon by Thor, *Calavo, Inc.* v. *Commissioner*, 304 F.2d 650 (9th Cir. 1962), *rev'g* 19 T.C.M. (CCH) 1359, P-H TC Mem.Dec. 60-1507 (1960); *Travis* v. *Commissioner*, 406 F.2d 987 (6th Cir. 1969), *rev'g* 47 T.C. 502 (1967); and *Rhode Island Hospital Trust Co.* v. *Commissioner*, 29 F.2d 339 (1st Cir. 1928), *rev'g* 8 B.T.A. 555 (1927), on the ground that ". . . the taxpayers were able to demonstrate on the evidence

46. In *Atlantic Discount* the taxpayer relied on general economic conditions, industry-wide data, and the banking bad debt reserve standards of banks that loaned to it, to justify additions to its bad debt reserve necessary to maintain the reserve at 2.5% of outstanding receivables. Similarly in *Coe* the taxpayer relied on industry-wide bad debt loss data, general business conditions, and changes in the nature of its own business.

The taxpayer in *Ehlen* unsuccessfully defended its policy of maintaining reserves at 2.5% of credit sales by relying on recommendations made in a prior year by an agent of the Internal Revenue Service. It also challenged the Commissioner's disallowance of some of the taxpayer's bad debt chargeoffs. The case is therefore distinguishable, since no question has been raised concerning the propriety of Thor's bad debt chargeoffs.

that the Commissioner's recomputation of their bad debt reserve failed to consider all the facts and circumstances and thus constituted an abuse of discretion" (Resp.Br. 75).

Those cases all held that the Commissioner had abused his discretion because he refused to consider current data on the collectibility of the taxpayers' accounts receivable. The Commissioner, commencing with the audit, steadfastly has taken the position that the *Black Motor* formula determined the reasonableness of Thor's bad debt writeoff. With this viewpoint, the Commissioner obviously treated as irrelevant the facts and circumstances upon which Thor determined that several accounts totaling some $184,000 were uncollectible. The essence of the Commissioner's position is vividly demonstrated by the fact that he does not challenge the accuracy of Thor's evaluation of its accounts, yet insists on the *Black Motor* formula. In contrast to the cases cited by Thor, the courts below did not require the Commissioner to consider the "facts existing at the close of the taxable year of the proposed addition" as required by Regulation § 1.166-4(b)(1).[47]

CONCLUSION

The theme that pervades Respondent's brief—consistent with the opinions of the courts below—is the supremacy of the Commissioner's discretion. The Treasury Regulations are added to the balance when they putatively support him on the inventory issue, but are ignored when they are not helpful on the bad debt issue. As the *amicus* brief of the Chamber of Commerce of the United States pointed out (pp. 16-20), the Commissioner has not been required to follow the procedural safeguards

47. The Seventh Circuit's opinion does not examine the facts at all, but relies exclusively on the Commissioner's discretion (Pet. A-48). The Tax Court likewise eschewed the facts in favor of an inference that ". . . collectibility was probably more likely at the end of 1965 than it was in at least some of the years upon which the Commissioner based his average because new management had been infused into petitioner" (Pet. A-32). There is nothing whatsoever in the record suggesting that former management, whatever else its faults, did not try to collect its receivables.

imposed on other administrative agencies. In this case the lower courts have enlarged his already great discretion to an unprecedented degree, upholding his determination that Thor's valuation of its excess inventory in 1964 and of its accounts receivable in 1965 did not clearly reflect income, without requiring him to show how or why Thor's valuations were inaccurate or distorted its taxable income. Respondent vigorously endorses these extremes, even to the point of supporting the right of the Commissioner to amend Regulations in 1970 to retroactively invalidate a change of accounting procedures made by the taxpayer in 1964. "It seems a tacit slander of the Nation's credit that need for money should drive us to such casuistry as this." *Lykes* v. *United States,* 343 U.S. 118, 129 (1952) (Jackson, J. dissenting).

* * *

For the foregoing reasons, and those set forth in its initial brief, Thor respectfully requests this Court to reverse the judgment of the Court of Appeals for the Seventh Circuit on both the inventory and bad debt issues.

Respectfully submitted,

MARK H. BERENS,
LEE N. ABRAMS,
JOHN E. ALLEN,
DOUGLAS A. POE,
231 South LaSalle Street,
Chicago, Illinois 60604,
312-782-0600,
Attorneys for Petitioner,
Thor Power Tool Co.

Of Counsel:
MAYER, BROWN & PLATT